

No. 10983.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

SUSAN AVERY JONES,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR THE PETITIONER.

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Opinion Below.

The opinion of The Tax Court of the United States [R. 14] is a memorandum opinion.

Jurisdiction.

This is an appeal from a judgment of The Tax Court of the United States entered October 10, 1943, in the amount of \$4,781.48 [R. 18]. Petition for review was filed January 5, 1945 [R. 23]. The allegation showing the existence of the jurisdiction of The Tax Court of the United States and of this Court are contained in the Petition filed with The Tax Court [R. 3-7] and the Petition for review [R. 19-23].

Question Presented.

Whether or not the taxpayer converted a vacant lot purchased for the purpose of building a personal dwelling thereon into a transaction entered into for profit so as to entitle her to a loss in 1940 upon sale of the property.

Statute.

The applicable statutes and regulations involved will be found in the appendix to this brief, pages 15 to 18.

Statement.

The case was tried to the Court and evidence consisted of the testimony of one witness for Petitioner, together with documentary evidence adduced by both parties.

Petitioner is an individual residing in Los Angeles, California. She filed her income tax return for 1940 with the Collector of Internal Revenue for the Sixth District of California. She is the widow of Grover Jones a highly successful author and scenario writer, who died in September, 1940.

In 1927 Petitioner and her then husband, Grover Jones, entered into a contract for the purchase of certain real estate in Beverly Hills, California, hereinafter referred to as Tiger Tail. The purchase price was \$16,500.00. Payments were completed in May, 1931, and at that time Petitioner and her husband received a deed to this property as joint tenants. The lot was irregularly shaped and at the time of purchase, Petitioner and her husband were advised by the broker that they would have no difficulty in buying an adjoining lot at a low price, which would fill out the tract to form a rectangular piece. Peti-

tioner and her husband purchased this property intending to build a home thereon. When the payments were finally completed and the deed received, Petitioner's husband commenced negotiations for the so-called corner lot which he felt was needed to complete the tract. The owner of this lot was a non-resident and when his price for the property was made known, Jones decided immediately that he would not pay it, but that he would build his home elsewhere. He asked his real estate broker to list Tiger Tail for sale and very soon thereafter purchased a residence on Sunset Boulevard, and occupied it with Petitioner as their home. During the period from June, 1931 to 1937 Petitioner and her husband purchased additional ground for the Sunset Boulevard home and eventually in 1937 razed the original building and erected a palatial mansion with extensive landscaping, elaborate dog kennels, a swimming pool and other improvements found only in the most expensive homes. The total cost was approximately \$250,000.00. Its original cost was not in excess of \$27,500.00.

When the Petitioner and her husband purchased the home on Sunset Boulevard they abandoned any intention to build their future home on Tiger Tail. During 1932 and 1933 they spent large sums of money improving it as a residential site, which included installations of a sprinkler system, a driveway, the building of a road along one side of the property, and other extensive improvements, including the planting of trees and shrubs. This was done in an effort to make the property more salable and to minimize their loss in this connection. No buildings were ever erected and the property never produced any income.

On several occasions Jones was offered \$10,000.00 for Tiger Tail and each time he refused to accept. He had become so enraged over his inability to acquire the small lot needed to complete Tiger Tail that he refused to sell unless he got his money out of it. On several occasions real estate men discussed with Jones the possibility of trades and exchanges for ranches but nothing ever came of these discussions. After Jones' death in September, 1940, Petitioner sold Tiger Tail for \$7,500.00. The value of Tiger Tail in May or June, 1931, when Petitioner and her husband purchased the home on Sunset Boulevard, was \$16,500.00. The money and effort expended by Petitioner and her husband after June, 1931, to promote the sale of Tiger Tail do not constitute a transaction entered into for profit.

In the income tax return filed by the Petitioner herein for the year 1940, there was deducted a loss of \$17,560.00 sustained upon the sale of the Tiger Tail property. The Commissioner of Internal Revenue disallowed said loss and on the 10th day of November, 1942, mailed to Petitioner what is termed a deficiency letter, wherein the Commissioner proposed a deficiency of income tax for the year 1940 in the sum of \$4,781.48. In due course of time, and within the 90-day period, Petitioner filed her appeal with The Tax Court of the United States wherein she alleged that Respondent had erroneously disallowed the loss of \$17,560.00 resulting from the sale of said Tiger Tail property. Thereafter The Tax Court of the United States entered its order determining a deficiency in tax against the Petitioner in the sum of \$4,781.48 [R. 18].

Specification of Error.

I.

The Tax Court of the United States erred in determining a deficiency in tax against the Petitioner for the year 1940, in the sum of \$4,781.48.

II.

The Tax Court of the United States erred in determining that the transaction resulting in a loss of \$9,000.00 to the Petitioner was not a loss sustained in a transaction entered into for profit under *Section 23(c)(2) of the Internal Revenue Code*.

III.

The Tax Court of the United States erred in that the conclusions of law set forth in its opinion are contrary to and not in harmony with the Court's findings of fact.

Summary of Argument.

The Petitioner was entitled to deduct the loss sustained upon the sale of the Tiger Tail property in 1940, for the following reasons:

1. When the Petitioner and her husband purchased other property for their residence in 1931, they abandoned the Tiger Tail property as a site for their personal residence. The expenditure of a large sum of money thereafter to make the property more salable and listing the property for sale constituted a conversion to a transaction entered into for profit.

2. This case does not come under the principle laid down in *Bowers v. Kerbaugh-Empire Company*, 271 U. S. 170, in which the court held that minimizing a loss is not a profit and which is cited by the trial court in the instant case as a reason why the Petitioner's loss is not allowable. While it is true that minimizing a loss is not a profit, it does not follow that the expenditure of money to minimize a loss deprives an individual of the right to deduct a loss sustained upon the sale of property under *Section 23(e)(1) and (2), of the Internal Revenue Code*.

3. *Heiner v. Tindle*, 276 U. S. 582, and later cases involving deductibility of losses sustained on sale of property converted from personal use to transactions entered into for profit, dealt with property which could be rented for dwelling purposes, a fact not possible in the instant case for the reason that there were no buildings on the property.

4. In view of The Tax Court's finding that the Petitioner and her husband had abandoned the Tiger Tail property when they spent large sums of money to improve it and make it more salable, listed it for sale and purchased other property at an ultimate expense of \$250,000.00, it is unreasonable to consider that the transaction was not converted into a transaction for profit.

ARGUMENT.

I and II.

Abandonment of Tiger Tail Property as a Residence Site and Purchase of Other Property for That Purpose and Expenditure of Large Sums of Money on the Tiger Tail Property to Make It More Salable, Constituted Conversion to a Transaction Entered Into for Profit.

There is no dispute on the facts in this case. They are clearly set forth in the findings of fact [R. 12]. The Tax Court found that the Petitioner and her husband abandoned any intention of building their home on the Tiger Tail property when they bought the new property on Sunset Boulevard prior to June, 1931; that during 1932 and 1933 Petitioner and her husband spent large sums of money improving the Tiger Tail property as a residential site which included installation of a sprinkler system, a driveway, building a road along one side of the property and other extensive improvements including planting of trees and shrubs. This was done in the effort of making the property more salable and to minimize their losses in this connection. No buildings were ever erected and the property never produced any income.

Petitioner submits that the expenditure of the money improving the Tiger Tail property after abandoning same as a site for a personal dwelling constituted converting the property into a transaction for profit. This money was spent to make the property more salable and at a greater price than it would have brought had the improvements not been installed. The receipt of more money even though at less than original cost is certainly a gain. The transaction in total may not produce a profit but the receipt of

more money certainly increases net worth and is a transaction for profit within the meaning of the Internal Revenue Code.

The Tax Court states in its opinion that minimizing a loss is not a profit, citing *Bowers v. Kerbaugh-Empire Company*, 271 U. S. 170. In this case a New York corporation prior to July 2, 1913, had borrowed money from the Deutsche Bank of Germany, amounting to \$1,983,000.00. The equivalent in marks was 8,341,337.50. The notes were payable in United States gold coin, or in marks. All of the moneys borrowed by the New York corporation were expended and lost in and about the performance of construction contracts. These losses were sustained in 1913, 1914, 1916, 1917 and 1918 and were allowed as deductions for income tax purposes. The amount of the loss exceeded the amount claimed by the Government to be income in the case. After the United States entered the war, the Deutsche Bank was an alien enemy. In 1921, on the demand of the Alien Property Custodian, the corporation paid in full settlement of the notes, \$113,688.23. The settlement was on the basis of two and one-half cents per mark. Measured by United States gold coin, the difference between the marks borrowed at the time the loan was made and the amount paid to the Alien Property Custodian was \$684,456.18. The Commissioner of Internal Revenue, notwithstanding the claim of the corporation that the amount borrowed had been lost in contract operations and that no income had resulted, held the difference set forth above to be income. The Court in its opinion stated, "The

transaction here in question did not result in gain from capital and labor, or from either of them, or in profit gained through the sale or conversion of capital." The Court thereafter stated "The loss was less than it would have been if marks had not declined in value; but the mere diminution of loss is not gain, profit or income."

It is submitted that there could be no question but what the payment of the debt by the New York corporation to the Alien Property Custodian was in connection with a business transaction and undoubtedly at the time the money was borrowed was in connection with a transaction entered into for profit even though resulting in a loss. The case, while stating minimizing a loss is not a profit, is no authority for a conclusion that the expenditure of money to minimize a loss is not a transaction entered into for profit within the meaning of the Internal Revenue Code.

In *General Counsels Memorandum 22272*, Cumulative Bulletin, No. 1940-2, page 214, the Chief Counsel, Bureau of Internal Revenue, rules that the sub-letting of an apartment by tenant who is required to change his residence to another city, is a "transaction entered into for profit," and that a loss sustained in such a transaction is deductible.

It is obvious that the apartment was sub-let at an amount less than was being paid by the original lessee, nevertheless the Chief Counsel to the Bureau of Internal Revenue interprets the transaction as being one entered into for profit and allows the deduction of the loss after citing *Heiner v. Tindle*, 276 U. S. 582.

In the case of *Heiner v. Tindle, supra*, the leasing of property for a long period of time demonstrates an intention on the part of the owner to convert the property formerly used for residential purposes to a business use and the loss on the sale thereof was allowed. The facts do not indicate whether the rents produced a profit or not, and this fact was not considered by the Court. The Court was dealing with the Revenue Act of 1918. This Act provided that in computing net income there shall be allowed as deductions losses sustained by individuals, if “* * * incurred in any transaction entered into for profit, though not connected with trade or business, * * *.” In dealing with this section the court stated at page 585, “But the words ‘any transaction’ as used in sub-section (a) 5 are not a technical phrase or one of art. They must therefore be taken in their usual sense, and so taken, they are, we think, broad enough to embrace at least any action or business operation, such as that with which we are now concerned, by which property previously acquired is devoted exclusively to the production of taxable income.” The Supreme Court has stated that the words “any transaction” embrace at least any action or business operation.

It would seem unreasonable to hold that the expenditure of large sums of money for the improvement of property would not be within the meaning of the words “any transaction” entered into for profit after the abandonment of the Tiger Tail property as a residential site, which in fact was never occupied as such or used as such by Petitioner.

All of the cases dealing with the disallowance of losses sustained upon the sale of property originally acquired for personal use have dealt with property easily convertible into a business use by renting. In this case the property was unimproved and could not be rented for business purposes. The Petitioner took the only logical and economical course that they could take in improving the property without the expenditure of many thousands of dollars by the erection of buildings for sale or rental purposes. Had Petitioner merely listed the property for sale without any further improvement, the case would undoubtedly be governed by the decisions cited by The Tax Court, however, in view of the admitted improvements, it is submitted that such improvements remove the transaction from a personal one to a transaction entered into for profit.

These improvements installed by Petitioner and her husband would be comparable to remodeling or reconditioning a residence which was stated as one method of converting personal property to business property in the case of *Morgan v. Commissioner*, 76 Fed. (2d) 390. In this case the Court stated, "The owner did not remodel or recondition the house, or do anything that specially devoted it to rental purposes." The Tax Court in its opinion stated that the improvements made by Petitioner and her husband were ordinary and customary for landscaping a tract for residential use.

We could agree with The Tax Court if the property had been improved with a residence, however, we submit that

it is not ordinary and customary to landscape a tract that is not occupied with a residence unless the owner has either an intention of building thereon his personal dwelling or of selling the property for a profit. The Court found that Petitioner had abandoned the property as a residential site, therefore the improvements could have been installed only for the purpose of realizing more money upon the sale thereof, and this fact was found to be true by The Tax Court also. The Court also states in its opinion that Petitioner and her husband could have at any time erected a home on Tiger Tail and had the benefits of the expenditures. The Court found as a fact that Petitioner and her husband expended approximately \$250,000.00 upon their Sunset Boulevard home. It is contrary to good reason to assume that Petitioner and her husband would expend approximately \$250,000.00 upon their Sunset Boulevard home and return to the Tiger Tail property after abandonment of same. This fact could be stated in any of the cases wherein the taxpayer had converted his residential property to business use by renting same for a period of years and later selling same at a loss which has been allowed by the Courts. All of these taxpayers could, had they so elected, undoubtedly have repurchased property they sold.

It is submitted that the Petitioner did convert the Tiger Tail property into a transaction entered into for profit and any loss sustained upon the sale thereof is allowable as a deduction in computing her net income.

III.

The Board's Conclusion Is Not Supported by Its Findings of Fact.

The Tax Court finds as a fact that Petitioner and her husband purchased the Tiger Tail property for \$16,500.00 for the purpose of erecting a home thereon; that prior to June, 1931, Petitioner and her husband purchased a home on Sunset Boulevard and during the period June, 1931, to 1937, expended approximately \$250,000.00 on this home; that when Petitioner and her husband purchased a home on Sunset Boulevard they abandoned any intention of building their future home on Tiger Tail.

That during 1932 and 1933, they spent large sums of money improving Tiger Tail as a residential site for the purpose of making the property more salable.

The Tax Court then concludes that the money and effort expended by Petitioner and her husband after June, 1931, to promote the sale of Tiger Tail do not constitute a transaction entered into for profit. Petitioner submits that the conclusion of The Tax Court is in error; that the facts found support the conclusion that the money and effort expended by Petitioner and her husband after abandonment of the Tiger Tail property as a home site did convert the property into an investment property and that the sale thereof was in connection with a transaction entered into for profit.

In view of the foregoing, it is respectfully submitted that the Board's opinion and decision based upon its findings of fact are contrary to law.

Conclusion.

In conclusion, it is respectfully submitted that Petitioner during the year 1940 made a sale of Tiger Tail property that was in connection with a transaction entered into for profit and any loss sustained represents a proper deduction in computing her income tax liability. The decision of The Tax Court should therefore be reversed.

Respectfully submitted,

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DARIUS F. JOHNSON,

Attorneys for Petitioner.

APPENDIX.

Statutes.

INTERNAL REVENUE CODE:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(e) **LOSSES BY INDIVIDUALS.**—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business.

TREASURY REGULATIONS 103:

Sec. 19.23(e)-1. **LOSSES BY INDIVIDUALS.**—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Internal Revenue Code: Sections 23(g) and 117, relating to capital losses; section 23(h), relating to wagering losses; section 24(b), relating to losses from sales or exchanges of property between persons designated therein; section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 118, relating to

losses on wash sales of stock or securities; section 251, relating to income from sources within possessions of the United States; and section 252, relating to citizens of possessions of the United States. See section 213 as to limitation upon losses sustained by nonresident aliens.

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. See section 113(b).

A loss occasioned by damage to an automobile maintained for pleasure, where such damage results from the faulty driving of the taxpayer or other person operating the automobile, but is not due to the willful act or negligence of the taxpayer, is a deductible loss in the computation of net income. If damage to a taxpayer's automobile results from the faulty driving of the operator of an automobile with which the automobile of the taxpayer collides, the loss occasioned to the taxpayer by such damage is likewise deductible.

No loss is realized by the transfer of property by gift or by death. But see section 44(d).

A loss on the sale of residential property purchased or constructed by the taxpayer for use as his personal residence and so used by him up to the time of the sale is not deductible. If, however, property so purchased or constructed is prior to its sale rented or otherwise appropriated to income-producing purposes and is used for such

purposes up to the time of its sale, a loss from the sale of the property, computed as provided in section 111, is, subject to the limitations provided in section 117, an allowable deduction in an amount not to exceed the excess of the value of the property at the time it was appropriated to income-producing purposes (with proper adjustment for depreciation) over the amount realized from the sale.

Example (1): Residential property was purchased by a taxpayer in 1929 for use as his personal residence at a cost of \$25,000, of which \$15,000 was allocable to the building. The property was so used by the taxpayer until January 1, 1936. From that date to January 1, 1939, when the property was sold, it was rented by the taxpayer. The fair market value of the property at the time it was rented on January 1, 1936, was \$22,000, of which \$12,000 was allocable to the building. The building had an estimated life of 20 years on January 1, 1936. The property was sold on January 1, 1939, for \$16,000. The loss from the sale allowable as a deduction, except as limited by section 117, is \$4,200, computed as follows:

Cost of property in 1929.....	\$25,000
Less depreciation allowed (not less than amount allowable) in respect of the building (depreciation for 3 years at 5 per cent based on \$12,000, value of building when converted to business use)	1,800
	<hr/>
	\$23,200
Selling price of property.....	16,000
	<hr/>
Loss computed as provided in section 111.....	\$ 7,200
	<hr/> <hr/>

Value of property at time it was rented on January 1, 1936	\$22,000
Less proper adjustment for depreciation.....	1,800
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	\$20,200
Selling price of property	16,000
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Portion of \$7,200 loss which is deductible except as limited by section 117\$ 4,200

Example (2): If, under the circumstances set forth in example (1), the property had been purchased at a cost of \$20,000, of which \$10,000 was allocable to the building, but otherwise the facts assumed are the same, the deductible loss, except as limited by section 117, is \$2,500, computed as follows:

Cost of property in 1929.....	\$20,000
Less depreciation allowed (not less than amount allowable) in respect of the building (depreciation for 3 years at 5 percent based on \$10,000, cost of building).....	1,500
	<hr/>
	\$18,500
Selling price of property.....	16,000
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Loss computed as provided in section 111.....\$ 2,500
Deductible loss, except as limited by section 117.... 2,500

Losses from the sale or other disposition of Treasury bills issued after June 17, 1930, are not deductible.